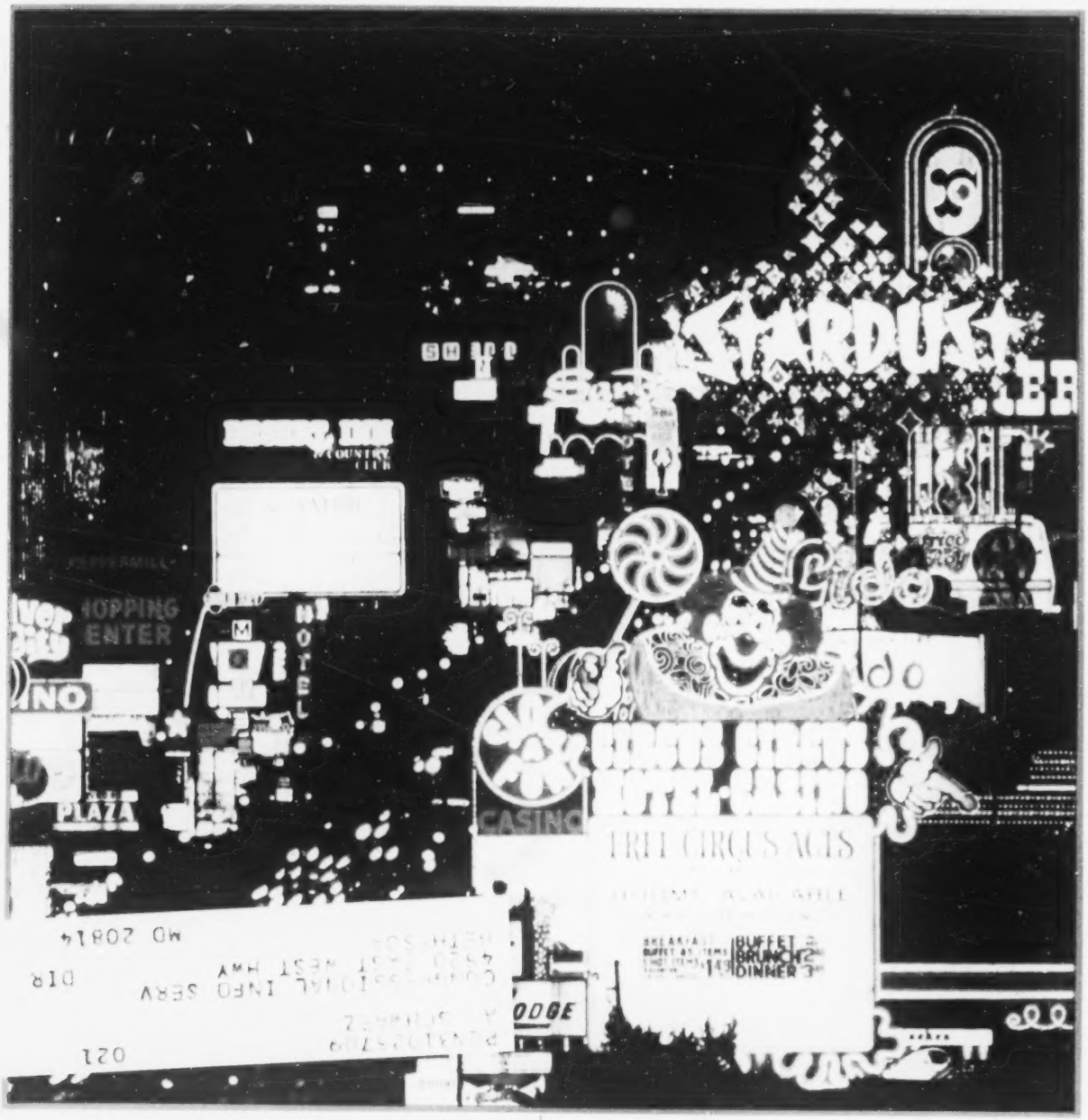
11/4/86 C2425-1

NOVEMBER 1986

Pension World

The Magazine for Plan Sponsors and Investment Managers/A Publication of Communication Channels, Inc



Pension World

November 1986
Volume 22 Number 11

The Magazine for Plan Sponsors and Investment Managers/A Publication of Communication Channels, Inc.

Features

The Multi-Employer Property Trust: Investing in union-built projects
Ronald Derven
More than 80 Taft-Hartley plans have pooled their funds in real estate investments. 30

Multiemployer fund offers more benefits, same contributions
Donald A. Walters
This fund used its investment surplus to provide extra checks to retirees. 37

***Emerging Trends 1987:* Real estate investment outlook**
Leanne Lachman and *Richard Kateley*
An excerpt from *Emerging Trends in Real Estate: 1987* looks at investment prospects. 40

How do plan liabilities affect mergers and acquisitions?
William T. Cleary
The pension plans of a potential acquisition must be examined carefully. 50

When is a GIC not a "real" GIC?
Harold Morley and *Larry Mylnechuk*
It's necessary to read the fine print to tell the difference. 58

FASB 88 procedure regulates recapture of surplus assets
Hersh L. Stern and *Artemus B. Engle*
How FASB 88 allows recognition of a portion of surplus assets as income. 62

"Floor plans"—a cure for the defined benefit blues?
Richard R. Joss and *Rolf Trautmann*
A combination plan can be more attractive than the old standby. 64

Oil and gas investing today: Not for the fainthearted
Ward S. Merrick III
Prices are low right now, but investors are understandably wary. 76

Departments

Calendar	71	Executive Suite	28	Pension World News	12
Current Issues in Plan Design	80	Guest Editorial	4	Pension Resources	68
		Letters to the Editor	6	Perspective on Investments	82
				Washington Commentary	8

***Cover:* Las Vegas glitters by night. Photo courtesy of Las Vegas News Bureau.**

Pension World is published monthly by Communication Channels, Inc., George E. Fowkes, Chairman of the Board; B.J. Kotsher, President; Scott Smith, Secretary; Buford Bryant, Treasurer. Editorial and advertising offices at 6255 Barfield Road, Atlanta, GA 30328. Telephone (404) 256-9800. Telex 4611075COMCHANI. *Pension World* is a registered trademark of Communication Channels, Inc.

1986 by Communication Channels, Inc.

Second class postage paid at Atlanta, GA, and at additional mailing offices. Subscription rates: U.S., 1 year, $41; 2 years, $68; Canada and Mexico, 1 year, $44; Overseas Sea Mail, $59; Overseas Air Mail, $81. Single copies, $3.50. Group rates available. The opinions expressed by authors and contributors to *Pension World* are not necessarily those of the editors or publisher. Articles appearing in *Pension World* may not be reproduced in whole or in part without the express permission of the publisher. Microfilm copies of *Pension World* are available from University Microfilms, 300 North Zeeb Road, Ann Arbor, MI 48106. Postmaster: Please send form 3579 to Circulation Department, *Pension World*, 6255 Barfield Road, Atlanta, GA 30328.

BPA

ISSN 0098-1753

Emerging Trends 1987: Real estate investment outlook

Despite the doomsayers, less than four percent of America's investment grade real estate is in trouble.

Pension World is pleased to present an excerpt from the forthcoming report *Emerging Trends in Real Estate: 1987,* an annual publication of Real Estate Research Corporation, Chicago. This material is derived from Chapter 2, "Real Estate Investment Outlook."

Reprinted with permission of Real Estate Research Corporation. For copies of the full report, contact Real Estate Research Corporation, 72 West Adams, Chicago, Ill. 60603, (312) 346-5885. Cost of the full report is $8.00.

The vast majority of investor-owned real estate will produce adequate returns in 1987. Times will be tough for undercapitalized developers and investors with buildings that are leasing slowly, for the 200 or 250 severely troubled savings and loans, for highly leveraged syndications with vacancy problems and for deep-tax-shelter syndications that still need several more years of limited partner contributions.

These problems notwithstanding, less than four percent of America's investment-grade real estate is in trouble (i.e., behind in loan payments). The rest is perking along, providing shelter for workers, travelers, and residents and satisfying the owners' investment requirements.

Yields on investment real estate have dropped over the last 18 to 24 months, as have interest rates and bond yields. Table 1 presents the comparative yields for real estate investment trusts (REITs), pooled real estate funds for institutional investors, indexed government and corporate bonds and the S&P 500 through year-end 1985.

Although the two forms of real estate investment did well until last year, outperforming stocks and bonds in average total return from 1977-84, they did not compare at all favorably in 1985. The '86 comparison with bonds will be somewhat more positive, but the stock market has clearly generated superior returns this year.

Financial planners advocate portfolio diversification into real estate to take advantage of the countercyclical relationship between stock and real property returns. From 1977-79, as reflected in Table 1, pooled real estate funds produced an average annual return of 16.8 percent while the S&P 500 yielded only 6.3 percent a year. Now the situation is reversed.

Real estate's inflation protection is not particularly relevant when the Consumer Price Index is only going up 2.5 to 4 percent a year. Traditionally, an investor in good quality properties could expect a cash return of 8-11 percent, as reflected in the "Income Return" columns for REITs and pooled real estate funds. Cash returns have dropped, however, with today's extensive office oversupply. Even established, well-leased office buildings are forced to offer deep rent concessions to hold their tenants. Offices account for about half the properties in most pooled funds, so average cash yields are down—and will remain so for two to three years while the excess inventory is absorbed.

Investors are concerned about the negative effects that a serious recession would have on the overbuilt property market. If tenants' space usage began shrinking instead of expanding and if bankruptcies rose significantly, many more properties would become troubled. (Imagine Houston and Oklahoma City replicated many times over!) Two-thirds

by **LEANNE LACHMAN**
President
and **RICHARD KATELEY**
Executive Vice President
Real Estate Research Corporation
Chicago, Ill.

of the *Emerging Trends* interviewees do not anticipate a national recession in 1987; yet all recognize the economy's poor performance and acknowledge that it could worsen.

This concern is reflected in the current four-point differential between the average yields on Moody's Aa Utilities and the median yields expected from top investment-grade real estate being acquired for institutions. In the past, the yield spread between those two investment alternatives has commonly been closer.

'87 price trends

Capitalization rates (or going-in annual rates of return) remain low for investment real estate. The predominant focus here is on office, retail, and industrial properties; the situation for apartments and hotels is muddier and precludes sweeping generalizations. For the three primary institutional land uses, prices are holding up—largely because the amount of money available for investment still exceeds the supply of good quality product. We do not anticipate a material change in this situation in 1987.

In fact, RERC's crystal ball shows considerable stability in real estate prices next year. We see values holding up for large institutional holdings and for smaller income properties. In the middle—where tax-oriented syndicators and aggressive thrift lenders have been most active—there will probably be price declines of 5 to 20 percent. But even in that category, occupied retail and industrial property prices are likely to hold up well.

RERC's quarterly survey of investment yields has looked at national market properties and good quality investment properties. This is where cap rates have stayed down—and 72 percent of the interviewees expect investors to continue accepting lower yields.

Most institutional investors are committed to real estate for the long term and believe that good properties will appreciate over time. They are prepared to ride out cycles of oversupply in order to be well positioned when markets tighten and when inflation returns. As will be discussed shortly, RERC expects the flow of funds available for institutional real estate investments to remain strong enough in 1987 to keep prices up, with the possible exception of hotels.

Table 1 Comparative Returns on Real Estate,

Year	REITs			Pooled real estate funds		
	Unrealized appreciation	Income return	Total return	Unrealized appreciation	Income return	Total return
1977	10.1%	8.0%	18.1%	3.2%	8.8%	12.0%
1978	– 8.5	8.4	– 0.1	8.0	9.6	17.6
1979	18.0	10.7	28.7	11.2	9.6	20.8
1980	10.5	9.7	20.2	8.9	9.3	18.2
1981	– 0.2	9.5	9.3	7.8	9.0	16.8
1982	17.1	10.0	27.1	0.6	8.5	9.1
1983	14.9	9.6	24.5	5.7	8.4	14.1
1984	3.9	9.2	13.1	5.4	8.4	13.8
1985	– 4.4	9.7	5.3	2.4	7.7	10.1
Arithmetic mean	6.8	9.4	16.2	5.9	8.8	14.7

Sources: *REIT Fact Book*, The National Association of Real Estate Investment Trusts, Inc.; *Real Estate Profiles*, Evaluation Associates, Westport, Connecticut, 1986; Shearson Lehman Brothers; Standard & Poor's; U.S. Department of Labor, Bureau of Labor Statistics; Real Estate Research Corporation.

In the press and in conversations among real estate professionals, the current focus is on the horrendous office and hotel overbuilding. Two mitigating factors are largely ignored: first, on a national basis, the retail and industrial markets are in good balance; and second, most well-located and established office buildings and hotels in the country are producing steady, if low, cash flows. In 1985, industrial properties in institutional portfolios covered by the Frank Russell Company Index produced an 11.8 percent return. Retail properties were almost as strong at 11.5 percent. Even the 8.6 percent return for offices was almost five points above the inflation rate. Witnessing this kind of performance, institutional investors—both domestic and foreign—are content to allocate a modest proportion of their diversified portfolios to real estate. Furthermore, RERC's projection is that commingled funds will yield 9 to 10 percent per year through the rest of the '80s.

"Most institutional investors are committed to real estate for the long term and believe that good properties will appreciate over time."

We are not so sanguine about the country's large supply of average and below-average investment properties. Some will perform well for their owners, but highly leveraged buildings with substantial vacancies will pose problems for developers, investors, lenders and, in the worst cases, even tenants.

This is the property category in which most foreclosures are occurring—and where defaults will accelerate in '87. Because tax-oriented syndicators have paid premium prices for apartment buildings, non-CBD hotels and speculative office buildings in the past, prices in this category are declining. Again, this is not happening across the board, nor will it, but a lot of investors and lenders will see their asset values drop.

In the broad category of small income properties—from six-unit apartment buildings to 20,000-square-foot industrial buildings to 7-11s—prices are likely to hold up fairly well. As is always the case, some owners are overleveraged and will lose their buildings; but they are more than matched by the huge number of owners who carry no debt whatsoever on their properties. The typical small property owner will do just fine in 1987.

Three-quarters of all investment real estate represents properties built, financed, owned and rented by small companies and individuals. Although the industry is not necessarily dominated by "Ma and

Bonds and Stocks: 1977-1985

Shearson/Lehman Government/ Corporate Bond Index			S&P 500 stocks			
Unrealized appreciation	Income return	Total return	Unrealized appreciation	Income return	Total return	CPI
-4.3%	7.3%	3.0%	-8.4%	4.6%	-3.8%	6.8%
-6.5	7.7	1.2	3.4	5.3	8.7	9.0
-6.2	8.5	2.3	8.4	5.5	13.9	13.3
-6.9	10.0	3.1	26.4	5.3	31.7	12.4
-4.8	12.1	7.3	-8.2	5.2	-3.0	8.9
16.1	15.0	31.1	11.9	5.8	17.7	3.9
-3.3	11.3	8.0	21.2	4.4	25.6	3.8
2.5	12.5	15.0	-0.3	4.6	4.3	4.0
9.1	12.2	21.3	19.2	4.2	23.4	3.8
-0.5	10.7	10.3	8.2	5.0	13.2	7.3

Pa" operations, it is still local entrepreneurs, builder/developers and financial institutions that account for the bulk of commercial property. *Builder Magazine's* most recent survey (1985) indicates, for example, that the 100 largest homebuilders account for only 11 percent of the single-family market.

A similar pattern emerges in retail. Most shopping centers (65 percent) are under 100,000 square feet. Those with less than 200,000 square feet constitute about half the gross leasable area (GLA) in the nation, compared with 12 percent for centers over a million square feet. In the multifamily sector, six out of 10 apartment complexes contain fewer than 10 units. Only 14 percent of existing apartment units are in buildings that have more than 100 units.

Sources of equity

RERC's prediction that overall real estate prices will hold up in 1987 is based on the assumption that more than enough equity and debt funding will be available. All signs are that this presumption is reasonable.

Real estate equity comes from four general sources: domestic pension funds; foreign institutions and individuals; Americans' personal retirement accounts—IRAs and 401(k) and Keogh plans; and individual direct investors. Although the volume of funds from each source varies from year to year, the overall flow has been fairly steady throughout the 1980s.

In 1987, pension investment in real estate is likely to remain constant. IRA and other individual retirement funds will drop somewhat. Individual investors will account for far less new equity than in their peak year of 1985; however, lower funding from this source will largely be balanced by foreign investors, who are once again buying heavily in the U.S. In the aggregate, ample equity will be available for the reduced level of real estate activity in '87.

"Three-quarters of all investment real estate represents properties built, financed, owned and rented by small companies and individuals."

Considering that new commercial construction volumes will be down significantly and, therefore, that equity investment will be directed primarily toward existing property acquisitions, we expect a continuation of the "more money than product" syndrome. Hence, prices will stay up.

- **Pension funds** will invest in real estate just as heavily next year as they have in 1986, according to 81 percent of the *Emerging Trends* interviewees. This is a much stronger prediction than last year's, when only 67 percent of RERC's respondents anticipated a continued heavy flow of pension investment.

The pension funds' real estate advisors and investment managers agree with our interviewees about new funding in '87. Corporate pension fund investment in real estate has slowed somewhat in 1986, and that pattern is expected to hold for '87 as well. However, an aggressive move into real estate by public pension funds is more than compensating for the shortfall on the private side.

A number of factors explain the somewhat lower flow of new equity from private pension funds:

1. The most obvious is plan terminations, which are triggering withdrawals from commingled funds.

2. Many corporate pension plans are now overfunded and consequently have no new cash to invest.

3. A number of the very large pension funds have reached their target allocations to real estate and are not inclined to increase them in today's market.

Among the large pension funds most active in real estate are the "baby Bells," which are expected to invest heavily in '87 and '88 as they work toward a 15 to 20 percent allocation to real estate. Many smaller corporate funds are also bringing new equity to real estate, not yet having reached a significant threshold of diversification.

Of the limited number of private pension funds with over $3 billion in assets, about one-quarter now have real estate separate accounts—where they can exercise greater control, take more risk and anticipate higher returns. This pattern, though expected to spread, is not yet significant within the next tier of pension funds. Also, separate accounts are usually created with new dollar commitments to real estate; they aren't financed through withdrawals from commingled funds.

It is only since the early '80s that public pension funds have committed equity to real estate and in many states they are still precluded by statute from doing so. The New York State Retirement System, which has more than $30 billion in assets and has been an active mortgage lender for years, made its first equity real estate purchase about two years ago. The State of Wisconsin Investment Board has two

percent of its $13.5 billion in real estate now, but its target allocation is 20 percent.

Pension advisors estimate that public funds have already adopted allocation plans that would commit an additional $15-20 billion to real estate. That translates into $4-5 billion annually.

RERC estimates that private and public pension funds had equity real estate investments of $59.8 billion by the end of 1985. This reflects an increase of $2.7 billion over the year-earlier number.

• **Foreign investors** have made much higher equity commitments to U.S. real estate in '86 than in the last three years. And 96 percent of the *Emerging Trends* interviewees believe that foreign investment will keep going up in '87. Last year, about half the respondents said they were seeing more interest in American real estate from abroad. In 1986, 61 percent report direct dealings with foreign investors—and three-fourths cite the Japanese.

As we emphasized last year, the Japanese are by far the most significant new overseas investors—and certainly the most talked about. Because their activities are so varied and their equity in U.S. real estate is growing geometrically, RERC has once again included a special summary (see accompanying sidebar) on Japanese real estate investment. Total Japanese equity commitment is unknown, but the net figure for '86 is probably between $2.5 and $3 billion. It is expected to double in '87. This volume of new money flowing into investment-grade real estate reinforces our conviction that prices will stay up.

The Japanese are by no means the only foreign investors in America, nor are they the biggest in aggregate holdings. Canadians are a major continuing force, particularly with BCE Development's acquisition of Daon and Oxford Properties and with Olympia and York's aggressive development and investment. The British are very active, being credited by the *New York Times* with owning $1 billion of investment real estate in Washington, D.C. alone. Then there are the Dutch, West Germans, Swiss, Australians, Indians, Middle Easterners and South and Central Americans.

On average over the last eight years, foreign investors have probably introduced $10 billion of new money to the U.S. real estate market annually. The 1987 number will be higher.

• **Individual retirement plans** have generated a lot of money for real estate over the last few years. It has been estimated by Robert A. Stanger & Co., for example, that up to half of the nearly $12 billion raised by public syndicators in 1985 came from IRAs, 401(k) plans and Keogh accounts. The average investment was reportedly $5,000. REITs have also attracted money from individual retirement accounts.

As individuals accumulate larger sums in their various retirement accounts—and become more informed about alternative investment vehicles—real estate's appeal grows. Like pension fund managers, individuals value the cash yields from income properties and recognize their implicit inflation protection.

The new tax law will dramatically reduce the amount of new money that will flow into individual retirement accounts. Nevertheless, there

Japanese Investment in U.S. Real Estate

Escalating Japanese investment in U.S. property is one of today's major real estate trends. Direct equity investment from Japan—over and above capital committed to manufacturing plants and equipment—will double in 1987, as shown below.

Estimated Japanese Direct Equity Investment

1985	$1.2 to $1.5 billion
1986	$2.5 to $3.0 billion
1987	$5.0 to $6.0 billion

Source: Real Estate Research Corporation

This nearly exponential growth means that Japanese investors are no longer tentatively testing the market: they are mainstream, steady participants in equity and debt finance, in new project lending and in construction. Underlying this surge are the following factors:

• Japan is awash in more investment capital than can be absorbed domestically, in part because the savings rate (15-20 percent of gross income) is so high, in part because of a worldwide favorable balance of payments and in part because of the underlying strength of the yen.

• Alternative yields are less attractive than the 8-10 percent expected of U.S. real estate. In Japan, property transfers infrequently, prices are exorbitant and returns are in the 2 to 4 percent range.

• The Ministry of Finance permits pension funds to invest 25 percent (formerly 10 percent) of their funds outside Japan. Officials are also authorizing second-tier insurance companies to invest in foreign real estate. Diversification is therefore a matter of government policy as well as private initiative.

Although still relatively small in number, a wider variety of Japanese players are now involved in American real estate:

Insurance companies. Of the 20 or so large ones, six are currently purchasing U.S. real estate and three or four others are approved by the Ministry of Finance. Insurance companies do joint ventures (typically 50/50) and solo purchases. They are conservative, risk averse, seek the highest quality product and have the greatest experience among the various players with U.S. markets and American partners.

Banks include trust banks and so-called city banks. They invest for their clients, who may be individuals as well as pension funds. Japanese construction lenders are aggressive in participations with American banks and in direct lending. They are outbidding money center banks by offering competitive rates on loans that don't require personal guarantees by developers.

Construction companies typically have not invested their own money, but that is changing and they are taking equity positions, as well as channeling capital from the banks and trading companies.

Japanese Investment (Continued)

These firms are doing some very large and very smart deals across the country. They operate as general contractor or joint general contractor and sub out most of the work to American companies. Like the banks, they are formidable competitors.

Trading companies, real estate companies, securities firms and **individual entrepreneurs,** along with the construction companies, are not regulated by Japanese authorities. They are involved in equity purchases, financing and development. Some make U.S. real estate available to individual Japanese investors. One such offering, marketed with the slogan "Let's Become Manhattan Landlords," reportedly sold shares worth $175 million in one day.

Emerging Trends interviewees who work with the Japanese report that their deals are no different than those with American partners. They favor the biggest cities on the coasts—New York, San Francisco, Boston, Los Angeles—followed by Washington, Philadelphia, Atlanta, and Chicago. Property preferences are skewed in favor of central-city highrises, including both hotels and office projects. Shopping centers and industrial/business parks are avoided, largely because they don't exist in Japan and investors don't understand how they work. Residential projects have appeal only in exceptional cases.

The Japanese choose people they know and trust as business partners and those relationships take time to develop. American institutions in on the ground floor (banks, insurance companies, investment bankers) will continue to be favored. They are also the ones with representative offices in Japan, so their share of the trade can be expected to expand.

RERC's experience with the Japanese suggests they don't yet fully understand the risks of U.S. real estate. Several factors contribute to this:

- Japanese observation of the industry has only been during the up cycle of development.
- It takes time to grasp the mobility of American tenants—and the costs associated with turnover. In Japan, tenants stay put.
- U.S. rents can go down as well as up, and land prices can do the same. This never happens in Japan.
- The speed and ease with which American markets become overbuilt—given the size of the country and the number of real estate players—is not fully appreciated.

As owners and lenders, Japanese investors will eventually come to grips with these issues and some of the romance of U.S. property may fade—but not before their stake in America grows. 1987 will see a big increase in that growth.

Source: RERC interviews.

will still be new savings to invest; the earnings from existing accounts will have to be reinvested; and some money will switch to real estate from money market and equity accounts. The large syndicators with good retail distribution affiliations can be expected to focus on individual retirement plan monies.

- **Individual investors** are the fourth major group that has generated a high volume of real estate equity over the last 10 to 15 years. This is where RERC expects a significant dropoff in 1987.

With the loss of real estate's tax shelter advantages and the widespread negative publicity about overbuilding and troubled real estate, smaller-scale retail investors will simply leave the market. This is already happening in the last half of '86—to the chagrin of limited partnership syndicators. Retail purchasers of $2,000 to $5,000 partnership interests have accounted for several billion dollars of new money in each of the last few years, so their loss will be perceptible in '87.

Every bit as noticeable will be the decline in tax-shelter-oriented investors in private limited partnerships. Robert A. Stanger & Co. estimates that $7.4 billion was raised by private real estate partnerships in 1985 and that the '86 figure will be lower by half. Not all private limited partnerships are deep tax shelters, but the majority were sold, at least in part, because they offered significant shelter in the early years.

Some opportunities exist to market income-oriented limited partnerships to balance the tax loss deals that people already own. It is hard to estimate the size of this potential, but it will be even harder to find enough solid income deals to serve this market.

Most new real estate projects don't stand up economically without deferred financing, hence the introduction of zero coupon bonds. Zeros make the deals harder for retail brokers to understand, let alone explain to clients. When buying tax shelter offerings, many investors felt they didn't need to understand the real estate—the presence of shelter was enough. For income-oriented investments, in contrast, the real estate is everything. Even when brokers are very well informed, complex deals are a hard sell.

The pension funds' steady flow of money and growth in foreign investment will balance the possibly decreasing interest from Individual Retirement Accounts and the loss of individual investors. With lower levels of new construction next year, the industry can expect plenty of equity capital to be available.

Mortgage financing

Mortgage money will also be readily at hand in 1987—from commercial banks, which still have low loan demand from other industries; from savings and loans, most of which have been doing well for the last couple of years; from insurance companies, which are having trouble peddling enough bullet loans because of the prepayment penalties; from mortgage companies like GE Credit; and from mortgage REITs and public partnerships.

Because ample money is out there, new construction projects can and will be financed—even though 57 percent of the experts interviewed for *Emerging Trends* candidly acknowledge that they see *no* market need for new construction

today. (Those who perceived demand for new construction generally mentioned residential or industrial potential in selected markets.) Despite the dollars around, all the interviewees foresee drastically reduced new construction in 1987. Consequently, most of the mortgage money will be used for acquisition of existing buildings and refinancings.

The commercial mortgage security (CMS) has been touted for at least three years as the next step in the securitization game—building upon the incredible success of residential mortgage-backed securities. From the issuer's perspective, securitization is a good thing: properly done, it enhances the movement of capital, increases the productivity of underlying assets, creates liquidity and, importantly, generates transaction fees.

The actual number of CMSs is small—but not because of a shortage of money. In large measure it's because there hasn't been a crying need for CMSs and they are time-consuming and expensive to put together—so much so that only very large deals can justify the cost. To date, securitization has been through private placement and/or the Eurobond market, and virtually all of the issues have included credit enhancement from third parties for a fee. Widespread acceptance of this product will require:

- Substantial investor education. Many investors and developers simply do not understand CMS and will be reluctant to use it until they are better informed.
- Public placement with the attendant requirement of SEC registration. The developer/owner has to disclose financial information (rent rolls, maybe specific tenant information) and registration takes time, but this will increase investor confidence.
- Rating systems that improve credibility with investors. S&P and Moody's are just beginning to deal with the complexity and risk of only the most vanilla real estate. Rating of pools and of large, complex properties is needed. Public capital markets require more information than has traditionally been available to real estate investors.

Table 1 documents the 4.4 percent decline in REIT prices in 1985—a far worse performance than that of any other generic investment. Despite that, RERC's interviewees believe by a margin of 66 to 34 percent that investor interest in REITs will rise in 1987. A key reason is that the new tax law favors the real estate investment trust. REITs already use 40-year depreciation, are strongly yield-oriented and don't pass through losses (over income). As a result, they will not be affected by the principal changes of the tax act.

In the short run, the liquidity features of REIT investments will be especially important. Many investors caught in limited partnerships with no market for their holdings have learned in spades what illiquidity means. This lesson will not be lost on others who want to invest in real estate in the post-shelter era.

"With understandable ghoulishness, a lot of attention is focused on troubled real estate . . . Although much of the industry gossip is true, what is lacking is the broad perspective."

RERC also expects that investor education about the advantages of REITs will improve in '87. Heretofore, few stock analysts have followed this investment option—for the obvious reason that there hasn't been enough money involved to make it worth their while. With renewed interest in REITs among individual investors and with more offerings brought to market, the stock brokerage firms should respond with better information and advice.

The new twist in the real estate security marketplace is the master limited partnership (MLP). Although introduced in the oil and gas business as early as 1981, MLPs have just come on the real estate scene. The NYSE-traded Burger King Investors Master Limited Partnership (fondly called A Piece of the Whopper) was offered in early '86 when Pillsbury raised cash by selling 128 Burger King properties and leases.

An MLP is a limited partnership in which the interests are tradeable on a securities exchange. The limited partners hold depository receipts as their shares, and these receipts can be bought, sold, margined, or transferred without the general partner's consent. Liquidity is the preeminent advantage of the MLP. In addition, unlike REIT investors, MLP shareholders have the benefits of partnership flow-through of gains and losses.

A master limited partnership can be offered on one or more properties. However, the newsworthy version of '87 is likely to be the two-tiered MLP. It is possible to create an MLP by rolling up a number of existing limited partnerships and converting them into a single master partnership, shares of which would be tradeable. Glenborough Ltd., for example, is an MLP created to acquire troubled limited partnerships and then turn them into income-oriented investments through restructuring and improvement. Whether this magic will be accomplished remains to be seen; but as an investment vehicle, this MLP has many of the attributes of a blind pool.

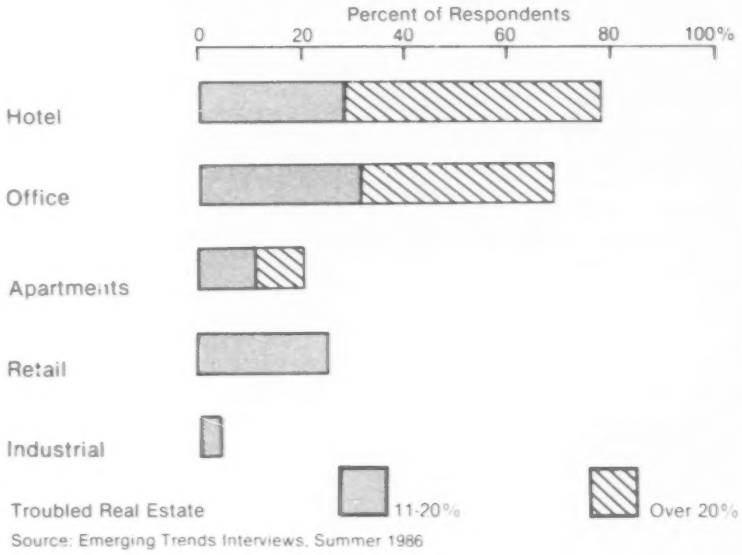
The tax and accounting intricacies of MLPs are still unfolding. Under the new tax act, however, it's a cinch that any product combining even a hint of shelter with liquidity will be a popular one for real estate investors.

Troubled properties

With understandable ghoulishness, a lot of attention is focused on troubled real estate—see-through office buildings, restructuring of tax-oriented syndications, S&L problem loans for ADC (acquisition, development, and construction), the 30 million vacant square feet in the Silicon Valley, and horror stories from Texas and Oklahoma. Although much of the industry gossip is true, what is lacking is the broad perspective: the size of the total real estate investment in the U.S. and the proportion of the total that is in trouble.

Inevitably, when asked about real estate trends, people focus on current projects more than on the mass of older established income real estate that does not attract special attention. Even the 99 experts interviewed for *Emerging Trends* fell into this trap. RERC asked them to

Figure 1 Percent of Respondents Estimating That More than 10% of U.S. Real Estate Is in Trouble



Source: Emerging Trends Interviews, Summer 1986

estimate the percentage of troubled projects in each land use category. We emphasized that they were to think about *all* investment in property and guess at the amount of distress in that context, but their answers clearly reflect a concentration on newer buildings.

Figure 1 presents the interviewees' guesses about troubled real estate. The majority thought that less than five percent of retail and industrial investments were in difficulty. However, they estimated that over 20 percent of hotels, over 11 percent of office buildings and over five percent of apartments were experiencing financial problems. This is not factually supportable.

RERC's rough calculation is that three to four percent of the total investment real estate in the United States is in trouble. (This does not include owner-occupied housing, which is in far better shape, even though mortgage defaults have gone up over the last two years. The estimate also includes farms and manufacturing facilities).

America has about $3.7 trillion invested in privately owned multifamily and income-oriented commercial property. Of that total, an estimated $970 billion is in investment-grade commercial holdings (including large apartment projects). RERC calculates that about six percent of the investment-grade properties are in trouble—and that the ultimate cash loss will amount to as much as $6 to $7 billion (a lot of money but still only 0.7 percent of the total investment).

According to these calculations, investment-grade properties constitute 26 percent of all income real estate. The vast majority of properties are actually small, old and/or used directly by the owners for their businesses. Much of this property is not mortgaged and most is fully occupied. Hence, the ratio of "trouble" in this portion of the inventory is far lower—three percent or less.

In the aggregate, troubled commercial real estate represents three to four percent of the whole. That is far below the perceptions of either the general public or most industry professionals.

At the same time, the current "trouble rate" is four times higher than the less than one percent that can be considered normal. We are certainly not making light of today's financial problems in commercial real estate. For large numbers of owners, lenders and developers, the situation is very serious. Furthermore, when troubled properties are clustered, they can blight surrounding buildings. Still, in looking at the industry, the tribulations of overextended individuals and financial institutions should be considered in the context of total real estate investment. With that perspective, most real estate projects are in good shape. □

Emerging Trends in Real Estate: 1987 was written by Leanne Lachman, president, and Richard Kateley, executive vice president of Real Estate Research Corporation. The findings are based on in-depth interviews with 99 leading real estate investors, lenders, syndicators and developers. For the second consecutive year, *Emerging Trends* has been underwritten by Equitable Real Estate Investment Management Corporation.

Lachman

Kateley

M. Leanne Lachman is president and chief executive officer of Real Estate Research Corporation, Chicago, a consulting firm devoted solely to land-use decisions. She joined RERC in 1960 and was elected president in 1979 at the age of 36, becoming the youngest woman chief executive officer of a major Chicago corporation. She holds a B.A. from the University of Southern California and an M.A. from Claremont Graduate School. Ms. Lachman had published numerous articles and books on land economics and urban planning.

Richard Kateley is senior vice president of Real Estate Research Corporation. He directs RERC's Advisory Services Group, which helps corporations, financial institutions, pension funds and foreign investors structure real estate investment and asset management programs. He joined the firm in 1977 as vice president of administration. Mr. Kately holds a bachelor's degree from the University of Texas at Austin and an M.A. from the University of Chicago. He is a co-author of *America's High-Rise Office Buildings* and *Asset Management: The Key to Profitable Real Estate Investment*.